United States Court of Appeals

for the Second Circuit

APPELLANT'S BRIEF

74-1680

ORIGINAL

To be argued by
RICHARD M. KRAVER

In The

United States Court of Appeals

For The Second Circuit

SECURITIES AND EXCHANGE COMMISSION,

Plaintiff-Respondent,

vs.

MANAGEMENT DYNAMICS, INC., EDWIN BARRETT, CLYDE GOFF, EPHRAIM HOFFMAN, PETER R. WATSON, GLOBAL SECURITIES, INC., ALLEN LANGENAUER, DAVID LANGENAUER, BERNARD OSCHERS, LEE SCHNEIDER, JOSEPH CIRELLO, FAIRFIELD SECURITIES, INC., THOMAS F. BRENNAN, III,

Defendants,

and

WILLIAM N. LEVY, A.J. CARNO, INC., ANTHONY NADINO, MAYFLOWER SECURITIES, INC. and SAMUEL D. HODGE,

Defendants-Appellants.

BRIEF OF DEFENDANTS-APPELLANTS A. CARNO, INC. AND ANTHONY NADINO

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THE ISSUES

1. Did the District Court utilize the proper standards in determining whether the SEC made a clear showing that it was entitled to injunctive relief against Carno and Nadino?
2. Did the District Court's decision set forth adequately the necessary findings of fact as required by Rule 52(a)?
3. Did the District Court properly find violations of Section 5 of the Securities Act after having properly considered the exemptions provided by §4(3) and §4(4) of that Act?
4. Did the District Court find any fact warranting the conclusion that Carno and Nadino misrepresented material facts or omitted material facts.
5. Was the District Court correct in stating that Carno and Nadino lacked sufficient information concerning Management Dynamics stock?
6. Has the SEC demonstrated that Carno lacked good faith, or was in some meaningful sense a culpable participant, to be liable as a controlling person under Section 20(a) of the Securities Exchange Act of 1934?

STATEMENT OF THE CASE

NATURE OF THE CASE

Appellants-Defendants, A. J. Carno, Inc. ("Carno") and Anthony Nadino ("Nadino") appeal from Order form the Honorable Robert L. Carter, United States District Judge preliminarily enjoining them from violating Sections 5(a), 5(c) and 17(a) of the Securities Act of 1933, as amended, and Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b5 promulgated thereunder in connection with the stock of Management Dynamics "or any other security" (132-135).

COURSE OF PROCEEDINGS

This action was instituted on July 13, 1973 by the Securities and Exchange Commission ("SEC") and on July 29, 1974 the SEC moved for a preliminary injunction. The S.E.C. allegedly predicated its motion on the grounds that

> "the conduct of the defendants demonstrates that they have acted contrary to the best interests of the public, that they have violated the law, and should be enjoined from further violations with respect to Management Dynamics securities and any other securities."
> (Deitz; Affidavit, §57) (41) .*

Mr. Nadino and Mr. Robert Berkson, president of Carno, submitted affidavits in which they emphatically denied the allegations made by the S.E.C., and emphatically denied having engaged in fraudulent activity when they offered to sell or sold Managment Dynamics stock (42-50).

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* Refers to the pages of the Appendix filed by the parties.

An evidentiary hearing was held on October 19 and 23, 1973 before the Honorable Robert L. Carter, United States District Judge for the Southern District of New York. At the conclusion of the plaintiff's case, Carno and Nadino asked the Court to deny the plaintiff's motion for a preliminary injunction and to dismiss the complaint against them. The Court reserved decision on this motion.

On March 29, 1974, Judge Carter enjoined Carno and Nadino from violating Sections 5(a), 5(c) and 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder in connection with Management Dynamics "or any other securities".

STATEMENT OF THE FACTS

At all times relevant hereto, Carno has always been and still is a broker dealer duly registered with the Securities and Exchange Commission. It presently maintains its principal place of business at 42 Broadway, New York City.

Anthony Nadino is the vice-president in charge of trading in Carno. He joined Carno in June, 1971 and began trading in the stock of Management Dynamics shortly thereafter. The record reveals that all of Carno's trading in Management Dynamics stock was initated by Mr. Nadino.

The thrust of the complaint is that Carno and Nadino quoted and traded Management Dynamics stock from August, 1972 to December 8, 1972, and that such activity violated the federal securities law. In support of this contention the S.E.C. introduced copies of the securities transaction questionnaire prepared by Carno from January 1, 1972 to December 1, 1972. (Plaintiff's Exhibit 11). This questionnaire lists all of Carno's purchases and sales of Management Dynamics stock during August 1972. In addition, the questionnaire reflects the fact that Carno and Nadino had been purchasing and selling Management Dynamics stock from as early as January 5, 1972.

Mr. Nadino discovered Management Dynamics' stock in June 1971, when he was looking for a stock to trade. The stock market was very quiet at that time. Brokerage firms were closing and Carno could only allocate a small allotment to Mr. Nadino for trading. As a result, Mr. Nadino looked for lowest price stocks because they fit into the monetary amount Carno allocated to him as a trader (Nadino, Tr. 349.)

Prior to the time that Mr. Nadino began trading Management Dynamics' stock in 1971, he inquired whether it had been previously traded. His investigation revealed that other reputable brokerage firms had been trading it for at least a year. Management Dynamics had been listed and quoted in the National Stock Summary since August 1970.

Before submitting his first quote, Mr. Nadino followed the trading activities of the other brokerage houses for more than a week before actually submitting a quote on the stock. Moreover, Mr. Nadino went to the trouble of checking with the National Stock Summary and was told that the stock had been listed and had been traded for all this time. Consequently, Mr. Nadino had good reason to believe and did believe that Management Dynamics stock was registered and freely tradable ("Nadino tr.325")

Upon cross-examination, Mr. Nadino was asked what factor determined the price of the stock. Mr. Nadino testified that the law of supply and demand is the governing factor for determining the price of the security ("Nadino tr. 352")

In light of this testimony, the District Court's ruling that Mr. Nadino violated the law by trading and quoting Management Dynamics stock upon the market in this security, rather than some standard based upon the activities of the company, is against the weight of the evidence and clearly erroneous. Moreover, this ruling fails to recognize the statutory exemptions conferred upon brokers and dealers in securities by Section 4 of the Securities Act of 1933. Consequently, the preliminary injunction was improvidently granted and should be vacated.

The District Court also ruled that Carno and Nadino violated Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934 by omitting facts in the case, cover letter and the press releases. This finding is clearly erroneous and against the weight of the evidence since Carno and Nadino had nothing to do with the preparation or dissemination of these letters or news releases. Consequently, the Court erred by finding violation of these provisions of the securities laws.

CARNO AND NADINO'S POSITION

The evidence does not support the S.E.C.'s condition that it was entitled to a preliminary injunction against Carno and Nadino. There is nothing in the record to justify the claimed violations of Section 5 and 17 of the Securities Act and 10(b) of the Securities Exchange Act. Moreover, if the Court should find that Mr. Nadino committed such violations, then there is no evidence warranting, imputing Mr. Nadino's wrongdoing to Carno under the good faith test of Section 20(a) of the Securities Exchange Act. Therefore, it is respectfully submitted that the preliminary injunction was improvidently granted and should be vacated.

ARGUMENT

POINT I

THE DISTRICT COURT ERRED IN GRANTING A PRELIMINARY INJUNCTION AGAINST CARNO AND NADINO SINCE THE S.E.C. FAILED TO SHOW THAT IT WAS ENTITLED TO A PRELIMINARY INJUNCTION

The District Court held that "when the S.E.C. seeks injunctive relief the test to be applied is whether a proper showing of need has been established." (130). Carno and Nadino respectfully submit that the test applied by the trial court in granting the S.E.C.'s motion for preliminary injunction is inaccurate as a matter of law.

At the outset, it is evident that the District Court applied a less strict standard simply because the plaintiff is the S.E.C. This is manifested by the statement, "when the S.E.C. seeks injunctive relief the test to be applied is whether a proper showing of need has been established." One cannot help but conclude that a different test would have been applied if the plaintiff were not a governmental agency. By itself, this kind of double standard constitutes a reversible error. S.E.C. v. Frank, 388 F.2d 486 (2d Cir., 1968); Ring v. Authors' League of America, 186 F.2d 637, 642-643 (2d Cir., 1951); S.E.C. v. Harwyn Industries Corporation, 326 F.Supp. 943 (S.D.N.Y. 1971).

As Judge Friendly currently reiterated in Missouri Portland Cement Co. v. Cargill, Inc., - F.2d -,Dkt. Nos. 74-1024 and 74-1025 (2d Cir., June 10, 1974), quoting from Sonesta International Hotels Corp. v. Wellington Associates, 493 F.2d 247, 250 (2d Cir., 1973), there are two standards governing the issuance of a preliminary injunction in case arising under the securities laws:

> "The settled rule is that a preliminary injunction should only issue upon a clear showing of either (1)probability of success on the merits and possible irreparable injury or (2) sufficiently serious questions going to the merits as to make them a fair ground for litigation and a balance of hardships tipping decidely toward the party requesting the preliminary relief." (Emphasis in original.)

The substantiality of the claimed violations of the securities laws allegely committed by Carno and Nadino, wholly fail to meet either of these requirements.

A. Absence of Probability of Success on the Merits.

At this stage of the litigation, it is not necessary to decide whether the S.E.C. has proved violations of Sections 5 and 17(a) of the Securities Act of 1933 or Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder. But, it is imperative for the District Court to decide that the S.E.C's proof was of sufficient substance to warrant the issuance of a preliminary injunction against these appellants. Gulf & Western Industries, Inc. v. Great Atlantic & Pacific Tea Co., Inc., 476 F.2d 687 (2d Cir. 1973).

The probability of success on the merits turns upon a clear demonstration that Carno and Nadino in some way participated in the wrongful conduct which is the subject of the Complaint. The absence of findings of fact by the District Court concerning the allegedly improper activities by Carno and Nadino creates the grave possibility that they were swept up by the possible wrongdoing allegedly committed by others. The only indications in the District Court's decision to warrant the preliminary injunction were the reference to (a) the August and October communications and the October press release omitted material fact with respect to Management Dynamics stock and (b) Carno and Nadino traded and quoted Management Dynamics stock at prices not related to the activities of the Company.

Firstly, since Carno and Nadino did <u>not</u> have anything to do with the preparation of the August and October communications or the October press release, they should not be held responsible for any material omissions contained in those documents. The record shows that the company's officers were solely responsible for the contents of those statements. Carno and Nadino simply received copies of them after they were prepared. Consequently, the S.E.C. failed to satisfy its burden of making a clear showing that Carno and Nadino violated Section 17(a) of the 1933 Act and Section 10(b) of the 1934 Act so as to justify the granting of a preliminary injunction.

The second reference to purported wrongdoing by Carno and Nadino concerns the trading and quoting of Management Dynamics stock at prices which the S.E.C. alleged were not related to the activities of the company. Without stating a single reason in support of its decision, the District Court concluded that the mere act of trading and quoting Management Dynamics stock constitute sufficient grounds for granting a preliminary injunction.

In judging the merit of this conclusion, it is important to note that the S.E.C. does not contest the fact that Management Dynamics stock had been listed in the pink sheets of the National Association of Securities Dealers and National Stock Summary as being traded by other reputable broker-dealers for well over a year before Mr. Nadino traded this stock. However, the S.E.C. attempted to gloss over this by claiming that Carno and Nadino failed to make the kind of inquiry required under Rule 15c2-11. For the reasons set forth in POINT V infra, S.E.C.'s contention is totally devoid of merit.

It is important to note that the District Court did not make any mention of the dealer's exemption provided by Section 4(3) or the broker's exemption provided by Section 4(4)

1933 Act and Section 10(b) of the 1934 Act so as to justify the granting of a preliminary injunction.

The second indication of alleged wrongdoing by Carno and Nadino concerns the trading activities of that firm. However, there was no demonstration of any improper trading activity by Carno or Nadino from the evidence which is part of this record.

The S.E.C. does not contest the fact that Management Dynamics' stock had appeared in the pink sheets of the National Association of Securities Dealers for well over a year before Nadino traded it. More importantly, the S.E.C. has not made a clear showing that Carno or Nadino failed to make the kind of searching inquiry they were required to make by S.E.C. Rule 15c-2-11. On the contrary, Carno and Nadino had good reason to believe, and did believe, that they were properly trading Management Dynamics stock. Except for two small transactions, all of their trading was done for their own account as dealers. These transactions were in small lots, and there were other several well established brokerage houses who were also making a market in Management Dynamics stock at that time. Consequently, Nadino and Carno had no way of knowing that they were trading unregistered stock.

It is important to note that the District Court did not make any mention of the dealer's exemption provided by Section 4(3) or the broker's exemption provided by Section 4(4)

of the Securities Act of 1933. Since the broker and dealer exemptions provide an automatic affirmative defense to the alleged violations of the registration provisions of Section 5, the absence of any findings with respect to the broker exemption or the dealer exemption renders the S.E.C.'s likelihood of succeeding on the merits exceedingly tenuous.

For all the foregoing reasons, Carno and Nadino respectfully submit that the S.E.C. failed to meet its burden of making a clear showing that it will succed on the merits of this action. Consequently, the preliminary injunction is defective as a matter of law.

B. Absolute Absence of Possible Irreparable Injury.

Assuming, without conceding, that the S.E.C. sustains its burden of demonstrating a probability of success on the merits, it still must make a clear showing of possible irreparable injury if the preliminary injunction is not awarded. Missouri Portland Cement Co. v. Cargill, Inc., supra; Sonesta International Hotels Corp. v. Wellington Associates, supra; Gulf & Western Industries, Inc. v. The Great Atlantic and Pacific Tea Co., Inc., supra; Checkers Motors Corporation v. Chrysler Motors Corp., 405 F.2d 319 (2d Cir.), cert. den. 394 U.S. 999 (1969).

Appellants, Carno and Nadino, respectfully submit that there is no possibility that the S.E.C. or the investing public would sustain irreparable injury if a preliminary injunction is not sustained. During the evidentiary hearing held in the

District Court, the S.E.C. conceded that all trading in the stock of Management Dynamics has been suspended since December 8, 1972. Since all trading in this stock is suspended, there is no possibility that irreparable injury could be sustained.

If the S.E.C. could show that it is still possible for Management Dynamics' stock to be traded notwithstanding the suspension, then Carno and Nadino respectfully submit that the S.E.C. still is not entitled to a preliminary injunction against them because the District Court did not even address itself to the critical question of whether the alleged violations create a reasonable likelihood that the wrong will be repeated. Chris Craft Industries, Inc. v. Piper Aircraft Corp., 480 F.2d 341, 385 (2d Cir. 1973); S.E.C. v. Manor Nursing Centers, Inc., 458 F.2d 1082, 1100 (2d Cir. 1972); S.E.C. v. Culpepper, 270 F.2d 241, 249 (2d Cir. 1959); S.E.C. v. Shapiro, 349 F.Supp. 46, 55 (S.D.N.Y., 1972).

The record of the evidentiary hearing manifests that Carno and Nadino are doing everything possible to adhere to the highest standards in the securities industry. Moreover, Carno and Nadino stopped trading Management Dynamics stock immediately after they were notified of the S.E.C.'s suspension order. Under these circumstances, it is apparent that

the failure to make a finding demonstrating the possibility of irreparable injury if the preliminary injunction constitutes reversible error. S.E.C. v. Frank, supra.

In view of the S.E.C.'s failure to make a clear showing that it is probable they will succeed on the merits, and its failure to make a clear showing that irreparable injury would ensue if the preliminary injunction was denied, Carno and Nadino respectfully submit that the preliminary injunction is defective as a matter of law and should be dismissed. Missouri Portland Cement Co. v. Cargill, Inc., supra; Sonesta International Hotels Corp. v. Wellington Associates, supra.

C. Absence of Meritorious Questions.

Under the two pronged test established by Missouri Portland Cement Co. v. Cargill, Inc. and Sonesta International Hotels Corp. v. Wellington Associates, the S.E.C. would be entitled to a preliminary injunction - even though it could not demonstrate probability of success on the merits or possible irreparable injury - if it could clearly show:

> "sufficiently serious questions going to the merits as to make them a fair ground for litigagion and a balance of hardships tipping decidedly toward the party requesting the preliminary relief."

Keeping this standard in mind, it is evident that the S.E.C. must, at the very least, establish a prima facie case before it can claim that there are sufficiently meritorious questions to sustain a preliminary injunction against Carno and Nadino. However, the record reveals that the S.E.C. lacked sufficient evidence to establish sufficiently serious questions against Carno and Nadino as to make them a fair ground for litigation.

In the First Count of the complaint, the S.E.C. alleged that Carno and Nadino violated Section 5 of the Securities Act of 1933. However, the evidence adduced at the hearing is insufficient to support the charge. It is manifest that the S.E.C. did not rebut the existence of the automatic affirmative defenses expressly provided by Sections 4(3) and 4(4) of the Securities Act. Moreover, the District Court's decision did not set forth findings of fact to support the conclusion that Carno and Nadino violated the registration provisions. Consequently, it is evident that there is a serious absence of meritorious questions sufficient to support an order preliminarily enjoining Carno and Nadino.

In the Second Count of the complaint, the S.E.C. alleged that Carno and Nadino violated the anti-fraud provisions of the 1933 Act and the 1934 Act by omitting to

state material facts. However, the record reveals that the S.E.C. has failed to establish any nexus whatsoever between the omissions of material facts contained in the August and October letters and the October press release with the activities of Carno and Nadino. Moreover, there is no evidence to support a finding that Carno or Nadino utilized these documents so as to become responsible for the omissions therein contained. Without any evidence linking Carno and Nadino to those persons who are responsible for the omissions contained in those written communications, the S.E.C. must be held as having failed to carry its burden of making a clear showing of sufficiently serious questions going to the merits to sustain its claim that Carno and Nadino violated Section 17(a) of the Securities Act of 1933, Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder. Consequently, the preliminary injunction is defective as a matter of law and should be vacated.

D. The Equities Favor a Reversal of Judge Carter's Decision.

Not only has the S.E.C. failed to establish sufficiently serious questions going to the merits to make them a fair ground for litigation, but it also failed to show that a balance of hardships tips "decidedly toward" granting preliminary relief.

For the three reasons set forth below, it is painfully clear that the balance of hardships tips decidedly toward vacating the District Court's order of preliminary injunction.

Firstly, the order of preliminary injunction not only forbids the future offer or sale of Management Dynamics' stock, but also encompasses "any other securities" whether or not directly or indirectly related to Management Dynamics' stock (131). Thus, any subsequent violation of the Federal securities laws may convert a civil infraction into a criminal transgression which is triable without a jury if the penalty imposed does not exceed six months' imprisonment. Frank v. United States, 395 U.S. 147 (1969); Cheff v. Schnackenberg, 384 U.S. 373 (1966); Mathews, S.E.C. Civil Injunctive Actions, The Review of Securities Regulations, Vol 5, No. 4 (1972).

A second consequence of the preliminary injunction may cause unforeseen economic damage to Carno and Nadino. The mere existence of a preliminary injunction automatically creates a disqualification from participating in a Regulation A offering by reason of Rule 252(c)(4) of Regulation A. Moreover, Section 9(a)(2) of the Investment Company Act provides that a person who has been preliminarily enjoined may not serve in the capacity of an employee, officer, director, member of the advisory board, investment advisor or depositor of a

registered investment company. These disqualifications arise by operation of law, and are indicative of the substantial hardships Carno and Nadino face if the preliminary injunction is upheld. This is especially true in view of the fact that Carno is a broker-dealer in securities and Mr. Nadino is its vice-president in charge of trading. In short, if the preliminary injunction is not vacated, upon this appeal, Carno and Nadino may be forever barred from performing the kind of business activities required of a broker-dealer in securities.

The third reason for vacating the preliminary injunction arises from the fact that the S.E.C. has already instituted administrative proceedings against Carno and Nadino based upon the same acts of purported wrongdoing, which are likely to result in severe penalties that are unwarranted in these circumstances. Thus, the interests of the public may be adequately redressed in the course of the administrative proceedings. Consequently, it is manifest that the balance of hardships tips decidedly toward vacating the order of preliminary injunction.

For all the foregoing reasons, Carno and Nadino respectfully submit that the S.E.C. failed to make a clear showing of sufficiently meritorious questions and a balance of hardships tipping decidely in its favor so as to entitle it to a preliminary injunction.

POINT II

THE DISTRICT COURT ERRED BY NOT SETTING FORTH ADEQUATELY THE NECESSARY FINDINGS OF FACT AS REQUIRED BY RULE 52(a).

Rule 52(a) of the Federal Rules of Civil Procedure expressly provides:

> "In all actions tried upon the facts without a jury...the court shall find the facts specially and state separately its conclusions of law thereon...and in granting or refusing interlocutory injunctions the court shall similarly set forth the findings of fact and conclusions of law which constitute the grounds of its action."

Although the District Court did prepare a memorandum opinion concerning the preliminary injunction, Carno and Nadino respectfully submit that the findings of fact constituting the grounds underlying the decision to grant the preliminary injunction are not set forth as required by Rule 52(a).

The propriety of an injunction against Carno and Nadino turns in no small measure on what they actually knew and did. The absence of any findings concerning the unlawful activities of Carno and Nadino create the gravest doubt as to what the District Court thought the facts to be. For this reason, the District Court's failure to make findings of fact constitutes reversible error. SEC v. Frank, 388 F.2d 486, 493 (2d Cir. 1968).

A plain reading of the District Court's decision indicates that the most significant reference to the allegedly improper activities of Carno and Nadino is the

following:

> "Nadino is Vice-President of A. J. Carno, Inc. He has been employed by Carno since June, 1971 and assumed charge of Carno's trading in September, 1972. He began Carno trading in MD shares in June, 1971, but at the time he knew nothing about MD. He made no inquiry of the SEC to determine whether MD shares were registered, and quotations submitted on Pink Sheets by Carno were based solely on the market for MD shares. The August and October letters, the October Press Release, data in National Stock Summary from April, 1970, to March, 1971, and an interoffice memorandum of November 28, 1972 of Filor Ballard & Smug constituted Carno's total information on MD. Between September 28, 1972 and November 15, 1972 Carno purchased 11,226 MD shares in the over-the-counter market and 9,825 of these were sold to Global." (125) .

There is nothing contained in the paragraph set forth above that shows any wrong doing by Carno and Nadino. More specifically, there is no statute, rule or regulation to sustain the conclusion that Carno and Nadino had a duty to inquire of the SEC to determine whether the stock of Management Dynamics was registered. This is especially true in light of the fact that the SEC concedes that Management Dynamics had been listed and quoted by various broker-dealers in the pink sheets of the National Association of Security Dealers and in the National Stock Summary commencing in April, 1970. Moreover, the mere fact that Carno and Nadino purchased Managment Dynamics stock in the over-the-counter market and resold many of these shares to Global Securities,

which is another broker-dealer interested in trading Management Dynamics' stock, does not constitute a violation of the securities regulations.

Apart from the paragraph set forth above, the only other references to Carno and Nadino concern their allegedly unlawful activities in connection with:

a) trading and quoting Management Dynamics' stock at prices unrelated to the activities of the company (128);

b) publishing quotations of Management Dynamics' stock allegedly without the kind of information required by Rule 15c2-11 (128); and

c) allegedly violating Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934 by omitting material facts in the August and October letters and the October press release (127).

For the reasons discussed at length in Points III, IV and V of this brief, Carno and Nadino respectfully submit that the District Court did not adequately set forth the necessary findings of fact as required by Rule 52(a) to sustain the conclusion that the preliminary injunction was providently granted.

POINT III

THE DISTRICT COURT ERRED BY PRELIMINARILY ENJOINING CARNO AND NADINO FOR TRADING AND QUOTING MANAGEMENT DYNAMICS STOCK IN VIOLATION OF SECTION 5 OF THE SECURITIES ACT SINCE ALL SUCH TRADING AND QUOTING IS EXEMPT FROM SECTION 5 BY SECTIONS 4(3) and 4(4) OF THE ACT.

In the First Count of the complaint, the S.E.C. alleged that Carno and Nadino offered and sold Management Dynamics stock in violation of Sections 5(a) and 5(c) of the Securities Act of 1933. Carno and Nadino denied these allegations and asserted as affirmative defenses the transactional exemptions provided by Section 4 of the Securities Act. Without setting for a single finding of fact concerning Carno and Nadino's affirmative defenses based upon the dealer's exemption and the broker's exemption from the registration requirements of Section 5, the District Court held Carno and Nadino's conduct in trading and quoting Management Dynamic stock at prices not related to the activities of the company was violative of the registration provisions of the Securities Act.

For the reasons set forth below, Carno and Nadino respectfully submit that everyone of the trades they effected in Management Dynamic stock qualifies for an exemption from Sections 5(a) and 5(c) of the Securities Act by reason of the dealer's exemption provided by Section 4(3), 15 U.S.C. §77d(3), and the broker's exemption provided by Section 4(4)

15 U.S.C. § 77d (4). Moreover, Carno and Nadino submit that the District Court's failure to state findings of fact or conclusions of law with respect to the non-applicability of these statutory exemptions creates the gravest doubt as to the propriety of preliminarily enjoining Carno and Nadino.

A. Applicability of the Dealer's Exemption.

Section 4(3) of the Securities Act of 1933 exempts from the registration provisions of Section 5 transactions by a "dealer". Although there are three limitations to the dealer's exemption, none of the limitations apply in these circumstances. Thus, the Section 4(3) exemption from the registration provisions is applicable to Carno and Nadino provided they come within the statutory definition of the term "dealer".

Section 2(12) of the Securities Act, 15 U.S.C. § 77b(12), defines the term "dealer" as:

> "Any person who engages either for all or part of the time, directly or indirectly, as agent, broker, or principal, in the business of offering, buying, selling or otherwise dealing and trading in the securities issued by another person."

It is manifest from the express language of Section 2(12) that both Carno and Nadino fall within the definitional orbit of the term dealer. The undisputed testimony at the evidentary hearing manifested that Carno is duly registered with the SEC as a broker-dealer in securities and all of its business affairs concern Carno's acting as an agent, broker or principal in the business of offering, buying, selling or otherwise dealing and

trading in securities issued by other persons. Moreover, the kind of activities performed by Mr. Nadino as the vice president in charge of trading at Carno constitute the kind of activities performed by dealers in securities. Since Carno and Nadino fall squarely within the definition of the term "dealer," Section 4(3) of the Securities Act provides them with an automatic exemption from the registration provisions of Section 5. Merger Mines Corp. v. Grismer, 137 F.2d 335 (9th Civ., 1943), cert. den. 320 U.S. 794.

Apart from the two unsolicited brokerage transactions, Carno and Nadino made upon the instructions of Samuel Hodge (that will be more fully discussed below), the undisputed testimony reveals that Carno and Nadino were acting as dealers, who offered modest amounts of what was then a widely traded security to other responsible dealers in securities. Consequently, Carno and Nadino are entitled to an exemption from Section 5 by Section 4(3) thereof. In addition, one of the releases published by the S.E.C. itself entitle Carno and Nadino to rely upon the dealer's exemption.

An examination of S.E.C. Release No. 33-4445 manifests that Carno and Nadino were well within the bounds of their dealer's exemption:

> "The amount of inquiry called for necessarily varies with the circumstances of particular cases. A dealer who is offered a modest amount of a widely traded security by a responsible customer, whose lack of relationship to the issuer is well known to him, may ordinarily proceed with considerable confidence. On the other hand, when a dealer is offered a substantial block of a little-known security, either by persons who appear reluctant to disclose exactly where the securities came from, or where the surrounding circumstances raise a question as to whether or not the ostensible sellers may be merely intermediaries for controlling persons or statutory underwriters, then searching inquiry is called for." (Emphasis added).

A review of Carno's security transaction questionnaire, which was marked Plaintiff's Exhibit 11, makes it evident that Carno and Nadino could proceed with "considerable confidence" in these circumstances. From the first transaction listed in Plaintiff's Exhibit 11, it can be seen that Carno and Nadino were offering a modest amount of Management Dynamics'stock to other dealers in securities, who had no relationship to the issuer. Moreover, for nearly two years, Management Dynamics' stock had been a widely-traded security that was listed in the National Stock Summary and National Association of Securities Dealers' pink sheets. Consequently, Carno and Nadino had good reason to believe they were acting lawfully and properly when they traded Management Dynamics' stock for their own retail account.

It is important to note that the District Court did not rule on the issue of whether Management Dynamics' stock was

a "widely-traded" security or whether it was a "little-known" security for purposes of the guidelines established by S.E.C. Release No. 33-4445. If this stock is held to be a "widely-traded" security, then the trading made for Carno's retail account is exempt for the reasons set forth above. On the other hand, if Management Dynamics' stock is held to be a "little-known" security, then Carno and Nadino submit they are still entitled to an exemption from the registration provisions because they did make the kind of searching inquiry called for.

S.E.C. Release No. 33-4445 expressly states "the amount of inquiry called for necessarily varies with the circumstances of particular cases." Up until the time that Mr. Nadino received a telephone call from the man named Buzz, he had traded and quoted only very small blocks of Management Dynamics' stock, and there was no indication from the surrounding circumstances to give cause for raising a question as to the propriety of Nadino's trading activities.

It is important to note the action taken by Mr.Nadino as the result of the telephone call from the man named Buzz. During this telephone conversation, Buzz told Mr. Nadino of his desire to sell 100,000 shares of Management Dynamics' stock. Alerted to the fact that Management Dynamics' stock never traded in such great volume, Mr. Nadino made the kind of searching inquiry called for. First, Mr. Nadino requested the stock certificate numbers of these shares. After Buzz

furnished them, Mr. Nadino contacted the transfer agent to verify that information. The transfer agent informed Mr. Nadino that the stock certificates described by Buzz were in the name of P. J. Watson.

Upon cross examination, Mr. Nadino testified that Buzz never sent the stock certificates to him. Mr. Nadino testified that he never even saw the stock certificates mentioned by Buzz nor does he know whether the stock existed. Moreover, Mr. Nadino testified that he did not know who P.J. Watson is, where he lives or whether he even exists.

Of significant importance is the fact that Mr. Nadino did not offer or sell any of the stock owned by P.J. Watson as a result of his telephone conversation with Buzz. Consequently, Mr. Nadino's conduct upheld the standards imposed by the securities industry by declining to offer or sell the Management Dynamics' stock which was the subject of this telephone conversation with Buzz.

In light of the fact that Mr. Nadino contacted the transfer agent to verify Buzz' request, he did make the kind of inquiry called for in the circumstances. Thus, Carno and Nadino did comply with all aspects of the guidelines of S.E.C. Release No. 33-4445. For all the foregoing reasons, Carno and Nadino respectfully submit that the District Court erred by preliminarily enjoining them from violating Section 5 without making any findings relating to applicability of the dealers' exemption.

B. Applicability of Broker's Exemption.

In addition to the dealers' exemption provided by Section 4(3), Section 4(4) exempts from the registration and prospectus requirements of Section 5:

> "Brokers' transactions executed upon customers' orders upon any exchange or in the over-the-counter market but not the solicitation of such order."

Although the Securities Act does not separately define the term "broker," "brokers' transactions" are encompassed within the definition of dealer provided by Section 2(12). Under Section 2(12), the brokerage exemption does not depend upon a finding that Carno and Nadino generally act as brokers; rather, the brokers' exemption depends upon the capacity in which they execute a particular transaction. Stacha Oil and Uranium Co. v. Wheelis, 251 F.2d 269, 275 (10th Cir.1957); 1 Loss Securities Regulations, p. 697.

Aside from the two unsolicited brokerage transactions executed upon orders from one Samuel Hodge, Carno and Nadino acted as dealers who purchased Management Dynamics' stock for Carno's trading account for resale to other broker-dealers. Consequently, it is clear that Carno and Nadino did not violate Section 5 since the two unsolicited brokerage transactions which were made upon a customer's orders are squarely within the express language of the brokerage exemption provided by Section 4(4) of the Securities Act.

For all of the foregoing reasons, Carno and Nadino respectfully submit that the District Court improvidently granted the preliminary injunction against them since there has been no showing that they violated Section 5 of the Securities Act.

POINT IV

THE DISTRICT COURT ERRED BY PRELIMINARILY ENJOINING CARNO AND NADINO FROM MISREPRESENTING FACTS CONTAINED IN DOCUMENTS THAT WERE ACTUALLY PREPARED BY OTHER PERSONS.

In the Second Count of the Complaint, the S.E.C. alleged that the defendants omitted to state material facts in "a press release, letters, statements of account and other information to investors." As the result of the evidentiary hearing, the District Court held that "the August and October letters and October press release omit material facts in respect of the conditional nature of" certain options held by the company (127).

Of significant and impelling importance is the fact that the August and October letters and October press release were not prepared by Carno and Nadino. The undisputed fact is that these documents were prepared by officers of the company itself and no responsibility for their misstatements can be imputed to Carno and Nadino.

By reason of the foregoing, it is evident that the entry of a preliminary injunction against Carno and Nadino is the result of the S.E.C.'s shot-gun allegations, which caused the District Court to lump Carno and Nadino with the other defendants. This was improper as a matter of law and necessitates that the preliminary injunction be vacated.

POINT V

THE DISTRICT COURT ERRED BY HOLDING THAT NADINO AND CARNO LACKED SUFFICIENT INFORMATION CONCERNING THE BUSINESS OF MANAGEMENT DYNAMICS BEFORE PUBLISHING A QUOTATION FOR THESE SECURITIES.

The District Court held that S.E.C. Rule 15c2-11 makes it

> "fraudulent for a broker or dealer to publish a quotation for any security unless the broker-dealer has information concerning the nature of the issuer's business, nature and extent of the issuer's facilities and financial information for at least two preceding years. These broker-dealers had none of this information on MD." (128-129).

At the outset, Carno and Nadino object to a holding that they were in violation of S.E.C. Rule 15c2-11 on the grounds that the S.E.C. did not allege a violation of Rule 15c2-11 in its complaint, or in its notice of motion for a preliminary injunction, and that Carno and Nadino were not

on notice that on notice that any violation of this provision was claimed. Consequently, it was improper to seize upon an alleged violation of Rule 15c2-11 to support the preliminary injunction against Carno and Nadino.

More importantly, the evidence adduced at the hearing establishes that Carno and Nadino did maintain a due diligence file required of them with respect to all securities traded for their retail accounts including Management Dynamics' stock. Since the record reveals that Carno and Nadino did have the kind of information S.E.C. Rule 15c2-11 requires them to have with respect to Management Dynamics' stock, the District Court's decision is contrary to the evidence adduced at the hearing with respect to the alleged violation of S.E.C. Rule 15c2-11.

POINT VI

IF IT IS HELD THAT NADINO WRONGFULLY TRADED MANAGEMENT DYNAMICS STOCK, THEN CARNO'S GOOD FAITH CONDUCT AND NON-PARTICIPATION IN NADINO'S WRONGDOING EXONERATES IT FROM WRONGDOING

The record reveals that Mr. Nadino is responsible for all of Carno's trading in Management Dynamics stock. No other officer, agent or employee of Carno traded Management Dynamics stock. It is therefore submitted that if Carno is liable for Mr. Nadino's trading in Management Dynamics stock, such liability

must be based upon Section 20(a) of the Securities Exchange Act of 1934. SEC v. Lum's Inc., 365 F. Supp. 1046 (S.D.N.Y., 1973).

In Lum's, the SEC contended that a brokerage firm should be held liable under a theory of respondent superior for a registered representative's fraudulent conduct. The brokerage firm countered by arguing that the presence of Section 20(a) as a means of imposing vicarious liability implied a Congressional intent that other theories of secondary liability were to be inapplicable under the 1934 Act. Judge Tyler rejected the SEC's position and held that Section 20(a), rather than the theory of respondent superior, was the applicable standard of liability. S.E.C. v. Lum's, Inc., supra at 1063.

The approached adopted in S.E.C. v. Lum's was followed in Gordon v. Burr, 366 F. Supp. 156 (S.D.N.Y., 1973), and recently reaffirmed in Barth v. Rizzo, - F. Supp. -, 73 Civ. 1014 (S.D.N.Y., July 26, 1974). Thus, the proper standard is exclusively found in Section 20(a) of the 1934 Act.

Section 20(a) of the Securities Exchange Act, 15 U.S.C.§78t(a), provides:

> "Every person who, directly or indirectly, controls any person liable under and provision of this chapter or any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such control person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action." (Emphasis added)

In Lanza v. Drexel & Co., 479 F.2d 1277, 1299 (2d Cir. 1973), this Court held that the purpose behind Section 20(a) is "obviously to impose liability only on those who fall within its definition of control and who are in some meaningful sense participants in the fraud perpetrated by controlled persons." Since Carno is concededly in control of Mr. Nadino's activities, the only question remaining is whether Carno established its good faith defense by demonstrating that it did not participate in Mr. Nadino's claimed wrongdoing. SEC v. First Securities Company of Chicago, 463 F. 2d 981,987 (7th Cir. 1972), cert. denied sub. nom., McKy v. Hockfelder, 409 U.S.880 (1972); Gordon v. Burr, supra, at 168; Barth v. Rizzo, supra.

The record discloses that Mr. Nadino is a registered principal who is the vice-president in charge of Carno's Trading Department. In the course of the evidentiary hearing, Mr. Robert Berkson, president of Carno, testified that Carno has a system of checks and balances with respect to all trading in securities. At the end of each day, Mr. Berkson inquired into whether there was unusual trading in a particular security. Mr. Nadino would report to Mr. Berkson anything requiring his attention. Carno also employs an accountant who supervises trading and reviews the order tickets daily. After the order tickets meet his approval, the accountant initials them (Berkson, Tr. 359-360.)

By the following day, the accountant has a computer print out to review. If any unusual trading is discovered, the accountant brings it to Mr. Berkson's attention. In addition, Mr. Berkson personally spot checks trading as well whenever he has the opportunity to do so. Thus, it is evident that Carno employed sufficient precautionary measures to establish its Section 20(a) good faith defense Lanza v. Drexel, supra; S.E.C. v. First Securities Co. of Chicago, supra; S.E.C. v. Lum's, Inc., supra; Gordon v. Burr, supra; Barth v. Rizzo, supra.

Based on the foregoing, Carno should be exonerated from any wrongdoing even if Mr. Nadino is deemed to have committed a violation.

CONCLUSION

The evidence does not support the S.E.C.'s contention that it is entitled to a preliminary injunction against Carno and Nadino. The record demonstrates that the S.E.C. failed to show that it had evidence to sustain the claimed violations of Sections 5 and 17 of the Securities Act and Section 10(b) of the Securities Exchange Act. Therefore, it is clear that the preliminary injunction against Carno and Nadino was improvdently granted, and it should be vacated.

Respectfully submitted,

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(212) 687-8930

Martin M.Frank
Richard M.Kraver
of Counsel

UNITED STATES COURT OF APPEALS
SECOND CIRCUIT

SECURITIES AND EXCHANGE COMMISSION,
Plaintiff-Respondent,

-against-

MANAGEMENT DYNAMICS,INC., WILLIAM N. LEVY, EDWIN BARRETT, CLYDE GOFF, EPHRAIM HOFFMAN, PETER R. WATSON, GLOBAL SECURITIES, INC., ALLEN LANGENAUER, DAVID LANGENAUER, BERNARD OSCHERS, LEE SCHNEIDER, A.J. CARNO, INC., ANTHONY NADINO, MAYFLOWER SECURITIES, INC., JOSEPH CIRELLO, FAIRFIELD SECURITIES, INC., THOMAS F. BRENNAN, III, SAMUEL D. HODGE,
Defendants.

73 Civ. 2642

AFFIDAVIT OF SERVICE BY MAIL

WILLIAM N. LEVY, A.J. CARNO, INC., ANTHONY NADINO, MAYFLOWER SECURITIES, INC. and SAMUEL D. HODGE,
Defendants-Appellants.

STATE OF NEW YORK, COUNTY OF NEW YORK) ss.:

DEBORAH LaMORTE, being duly sworn, deposes and says:

1. I am over 18 years of age, am not a party to this action and reside in Pelham Manor, N.Y.

2. On August 12, 1974, I deposited in a post-paid, properly addressed wrapper, in an official depository under the exclusive care of the United States Post Office within the State of New York, copies of the Memorandum of Law submitted by A.J.Carno, Inc. and Anthony Nadino to the following attorneys:

Frederick White,Esq.,Office of General Counsel,
Securities and Exchange Commission
500 North Capitol Street
Washington, D.C. 20549
Attorneys for Respondent

Bert Gusrae,Esq.
225 Broadway
New York,N.Y.10007
Attorney for William N. Levy

Borden & Ball
345 Park Avenue
New York, N.Y.10022
Attorneys for Mayflower Securities, Inc.

Dan Brescher,Esq.
230 Park Avenue
New York, N.Y.10017
Attorney for Samuel D. Hodge .

Deborah A. LaMorte

Sworn to before me this
12th day of August, 1974

Richard M. Kraver
Richard M. Kraver

RICHARD M. KRAVER
NOTARY PUBLIC, STATE OF NEW YORK
No. 4501234
Qualified in Westchester County
Term Expires March 30, 19 75

A 201 Affidavit of Service by Mail

LUTZ APPELLATE PRINTERS, INC.

US COURT OF APPEALS: SECOND CIRCUIT

SEC,
Plaintiff-Respondent,

against

DYNAMICS, INC.
Defendants.

Index No.

Affidavit of Service by Mail

STATE OF NEW YORK, COUNTY OF NEW YORK ss.:

I, Karen Giles, being duly sworn,

deposes and says that deponent is not a party to the action, is over 18 years of age and resides at 1013 East 180th Street, Bronx, New York

That upon the ~~18~~ 21st day of October 1974, deponent served the annexed ~~Joint Appendix~~ Brief

upon Lawrence E. Nerheim attorney(s) for

in this action, at 500 North Capitol Street, Washington, D.C. 20549

the address designated by said attorney(s) for that purpose by depositing 3 true copy of same, enclosed in a postpaid properly addressed wrapper in a Post Office Official Depository under the exclusive care and custody of the United States Post Office Department, within the State of New York.

Sworn to before me, this 21st day of October 1974

Robert T. Brin

ROBERT T. BRIN
NOTARY PUBLIC, STATE OF NEW YORK
NO. 31 - 0478050
QUALIFIED IN NEW YORK COUNTY
COMMISSION EXPIRES MARCH 30, 1975

Karen Giles

Print name beneath signature

KAREN GILES

A 202 Affidavit of Personal Service of Papers H LUTZ APPELLATE PRINTERS, INC.

US COURT OF APPEALS: SECOND CIRCUIT

SECURITIES AND EXCHANGE COMM.,
Plaintiff-Rdispondent,

against

MANAGEMENT DYNAMICS, INC., et al,
Defendants.

Index No.

Affidavit of Personal Service

STATE OF NEW YORK, COUNTY OF NEW YORK ss.:

I, Victor Ortega, being duly sworn,

deposes and says that deponent is not a party to the action, is over 18 years of age and resides at

1027 Avenue St. John, Bronx, New York

That on the 21st day of October 1974 at *

deponent served the annexed Brief upon

* the

in this action by delivering 2 true copy thereof to said individual personally. Deponent knew the person so served to be the person mentioned and described in said papers as the Attorney(s) herein,

Victor Ortega

Print name beneath signature

VICTOR ORTEGA

Sworn to before me, this 21st day of October 19 74

Robert T. Brin

ROBERT T. BRIN
NOTARY PUBLIC, STATE OF NEW YORK

ROBERT T. BRIN
NOTARY PUBLIC, STATE OF NEW YORK
NO. 31 - 0418050
QUALIFIED IN NEW YORK COUNTY
COMMISSION EXPIRES MARCH 30 1975

* Borden & Ball- 345 Park Ave., New York
* Daniel Befescher-230 Park Ave., New York
* Lipkin, Gusarae & Held-225 Broadway, NY